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REFORMING OBAMA-ERA FINANCIAL REGULATION

Insights from Eight New Research Papers

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About the Principal Investigator

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Calomiris also codirects the Hoover Institution's Program on Regulation and the Rule of Law and is comanaging editor of the *Journal of Financial Intermediation*. His book with Stephen Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (2014), was named one of the books of the year by the *Financial Times* and by *Bloomberg Businessweek*. Calomiris served on the International Financial Institution Advisory Commission, a congressional commission to advise the U.S. government on the reform of the IMF, World Bank, regional development banks, and WTO. His research spans banking, corporate finance, financial history, monetary economics, political economy, and economic development. He holds a B.A. in economics from Yale University and a Ph.D. in economics from Stanford University.

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Executive Summary

During the Obama era, federal regulators' treatment of the financial industry changed significantly, from the looser approach in the years leading up to the 2008 financial crisis to a more restrictive approach meant to prevent a recurrence of that event. Regulators imposed new rules on everything from leverage—how much a financial firm can borrow—to credit-card fees.

More than half a decade has passed since lawmakers and regulators made these changes. The Trump administration has signaled that it will revisit them to ensure that all existing regulations help advance several core new White House principles, including empowering Americans to make good financial choices, preventing taxpayer bailouts, and fostering economic growth.

Do the Obama-era laws and regulations help advance these goals? The Manhattan Institute invited eight teams of researchers—led by principal investigator Charles Calomiris, an MI adjunct fellow—from universities, as well as from government (see **Appendix**), to study how recent regulatory mandates have affected banks, credit-card companies, individual borrowers and savers, and the economy as a whole. The researchers discussed their findings at a December 2016 meeting chaired by Calomiris. In May 2017, they will present their papers at a public conference, to be chaired by Calomiris. In 2018, the papers will be released in a special issue of the *Journal of Financial Intermediation*, to be edited by Calomiris. This report summarizes and analyzes the papers' main findings.

Some limitations constrain their research. Many of the new regulations did not take effect until the past few years, so banks and other financial firms have not been through a whole economic cycle under them. Such a cycle would include a recession or an above-average or even average interest-rate environment.

The research conclusions, however, present causes for concern. Some new regulatory measures may harm growth, constraining credit for smaller corporate borrowers without making banks safer in return. Other measures may harm competition, keeping smaller banks from becoming larger banks, thus creating a protected class of preexisting large banks. Still other measures may shift customer costs rather than reduce them, both for bank-account holders and for credit-card borrowers with low credit scores.

Regulations are also inconsistent as to whether the government should be responsible for assessing financial risk or whether that task is the job of the bank executives who receive handsome compensation for doing so. This unclear responsibility makes it difficult to assess progress on the goal of protecting taxpayers from having to bail out big banks on the verge of collapse, i.e., ending too-big-to-fail. Finally, regulatory measures may be transferring risk from the heavily regulated banking system to more lightly regulated competitors—rather than reducing overall risk to the economy.

REFORMING OBAMA-ERA FINANCIAL REGULATION

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Obama-Era Regulatory Background

During his first two years in office, President Obama and a Democratic Congress enacted a pair of laws that have governed much of the new financial regulatory environment: the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (CARD Act); and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).

Outside the new laws, regulators have implemented rule changes under their preexisting discretion to do so. They have also imposed new and tighter rules to conform with changes to global regulatory guidance set by the world's major central banks under the Basel accords, named after the Swiss city where they are decided.

The CARD Act's goal was to help consumers, particularly borrowers with lower credit scores. The new law limited credit-card issuers' ability to impose late fees and penalty fees and to increase interest rates on existing balances.

Dodd-Frank's goals were more varied and complex. This law aimed to end taxpayer bailouts, in part by imposing rules governing size, borrowing, and investment activities at large banks to prevent their failure; it also required banks to undergo regular exams, "stress tests," to assess their ability to withstand an economic shock. In addition, the law aimed to protect consumers, in part by capping the fees that banks are able to charge retailers and other merchants for their customers' debit-card transactions. Finally, the new Basel-related rules address many of the problems that Dodd-Frank addressed, including banks' borrowing.

Basel and Dodd-Frank: Harming Economic Growth and Competition?

Banks support the economy partly by providing credit to businesses. Larger businesses can access the global bond markets and can take out bank loans; smaller and medium-size businesses, however, depend on bank loans.

In one research paper, "Bank Liquidity Management and Bank Capital Shocks," Robert DeYoung of the University of Kansas and Isabelle Distinguin and Amine Tarazi of the University of Limoges study the potential impact of a new Basel rule that requires banks to hold a certain percentage of liquid assets in addition to the existing requirement that they hold a certain percentage of all their assets in capital or in non-borrowed assets that serve as a buffer against possible future losses.

The purpose of the rule is to avoid a repeat of the 2008 financial crisis by protecting banks in the event that a negative event, such as an unexpected loss, eats into their non-borrowed capital. Were investors to get nervous and pull back from funding the bank, the idea is that the bank could sell some of its liquid assets without incurring more losses. Liquid assets are assets that the government and financial-industry actors consider to be easy to sell, such as Treasury bonds or U.S.-backed mortgage bonds.

The researchers find that the new rule is, at best, redundant. In studying data for 1998 to 2012, they conclude that banks already tend to increase liquidity when their capital levels, already long mandated by regulators, decline (usually because they are experiencing losses on loans or other investments). The smallest banks—community banks with assets below $1 billion—are particularly likely to take such precautionary action.

Banks increase their liquidity during tough times by taking one or all of three measures: reducing the amounts of loans they already hold; reducing new lending activity; and reducing dividends to shareholders. In other words, they increase liquidity even without being directed to do so by regulators.

Forcing banks to maintain additional liquid assets in a stressful period could constrain credit growth and hurt the economy without providing much new benefit, as the requirement to hold non-borrowed capital already provides a buffer against loss. Though the authors don't address the matter, such a measure could hurt competition as well. It would disproportionately affect smaller corporate borrowers who cannot access the global bond markets.

This liquidity rule could work against ending too-big-to-fail, too. Under the rule, it is the government, not the bank, which decides which assets are liquid. Such government determination can contribute to a herd mentality, in which financial institutions invest en masse in certain asset classes, such as mortgage securities. Such homogenous investment introduces systemic risk. If an asset class turns out *not* to be liquid in a crisis, this failure to assess risk will affect all banks, not just one bank.

A second paper also points to how new regulations may be reducing credit for smaller borrowers. In "Differential Bank Behaviors Around the Dodd-Frank Act Size Thresholds," Christa Bouwman, Shuting Hu, and Shane Johnson of Texas A&M University's Mays Business School study the impact of Dodd-Frank's disproportionate regulatory scrutiny of large banks: under Dodd-Frank, banks with more than $10 billion in assets face additional requirements, and banks with more than $50 billion incur even more.

Banks just below each threshold are taking actions to ensure that they remain below the threshold, the authors find. Such banks are growing their assets more slowly than larger banks. They are also charging borrowers higher interest rates for corporate loans, according to their analysis of borrowing rates over the past 15 years. Dodd-Frank "created costs" in terms of higher regulatory requirements for large banks that smaller banks "attempt to avoid by altering their growth and pricing behavior," they conclude. Large banks, by contrast, have not changed their behavior.

The authors theorize that banks below each threshold charge more to borrowers to make up for the prospect that such lending will bring them over the threshold, thus forcing them to incur higher regulatory costs. They theorize, alternatively, that small banks are making riskier loans, thus demanding higher interest rates, or that small banks may serve markets in which borrowers do not have a competitive choice.

Whichever conclusion is correct, the implications are not good for growth or for competition. Under one conclusion, small businesses are less able to borrow because of a constraint unrelated to their credit risk; their available lenders do not wish to grow bigger and to bear the cost of more onerous regulations. Under another conclusion, small banks must make riskier loans, perhaps because their larger competitors dominate the market for less risky loans.

Competition: A Closer Look

Dodd-Frank also could be constraining competition by discouraging smaller banks from merging and, thus, becoming big enough to compete with their entrenched larger brethren. In a separate study, "How the Dodd-Frank Act Affected Bank Acquisition Behavior," Bouwman, Johnson, and Shradha Bindal analyze data over the past 15 years to assess whether banks are making fewer acquisitions in order to stay beneath the $50 billion threshold that would trigger the greatest level of regulatory scrutiny under Dodd-Frank.

The authors conclude that such banks are indeed "less likely to engage in acquisitions." However, much smaller banks—those below the $10 billion threshold—are *more* likely to enter into such purchases or mergers.

The authors theorize that for the smaller banks, the benefit of growth may outweigh the additional regulatory costs; for larger banks, growing above $50 billion triggers such regulatory scrutiny that it is not worth the cost.

The conclusion raises concerns that Dodd-Frank has created a protected class of financial firms with assets above $50 billion, as smaller firms now have a reason *not* to reach that size. This is particularly true if one acquisition brought a bank just above the $50 billion threshold but didn't make that bank big enough to compete with the top tier of banks, each one of which possesses trillions of dollars' worth of assets. Dodd-Frank did nothing to break up America's largest banks, but it also discourages new competition for the mega-banks that existed before Dodd-Frank.

Risk: Reducing It or Shifting It Elsewhere?

Two studies raise the possibility that rather than reducing risk, post-2008 regulations may be moving it to harder-to-regulate areas of the financial markets. In "Do Higher Capital Standards Always Reduce Bank Risk? The Impact of the Basel Leverage Ratio on the U.S. Triparty Repo Market," Meraj Allahrakha and Jill Cetina of the U.S. Department of the Treasury and Benjamin Munyan of Vanderbilt University examine the impact of a 2012 Basel rule. Under the rule, financial regulators have imposed what's known as a pure leverage ratio on banks.

The rule differs from existing leverage limits, which limit banks' borrowing in accordance with the assets the banks borrowed to invest in. Under existing leverage limits, if a bank were borrowing to invest in Treasury bonds, it could borrow much more, as the government considered Treasury bonds to be risk-free; but if a bank were borrowing to make infrastructure loans, it could borrow less, as the government considered such bonds to be risky.

The researchers find that banks whose borrowing is limited under the 2012 Basel rule have indeed cut back on one particular type of financial transaction, thus theoretically reducing risk. The authors measure the volume of activity in the repo market, where banks lend money to one another on a short-term basis; the lending is backed by collateral, such as Treasury bonds or equities. After the rule took effect, in 2014, the banks reduced their overall activity in this market.

But the picture is mixed: before 2014, the banks dealt more in seemingly safer collateral, such as mortgage-backed bonds. After the rule went into effect, they reduced that collateral in favor of more volatile equities.

Now that banks do not have to pay a penalty under the new rule—in how much they can borrow—for dealing in the repo market in perceived riskier assets, such as equities, they may be seeking a higher profit. This conclusion could be positive, overall: the new Basel rule encourages banks to take responsibility for assessing their own risks in a smaller repo marketplace.

But the authors temper any such conclusion. They note that as banks have pulled back from holding traditional collateral, such as mortgage-backed securities, nonbank financial competitors—which are not covered under the rule—have increased their own activity in this market. At the same time, nonbanks have reduced their holdings in perceived riskier assets, such as equities, in favor of perceived safer assets.

This conclusion is less heartening. As banks seek to take more perceived risk for a given amount of borrowing, nonbanks are taking over the traditional repo business that posed the previous risk that the regulators sought to address by capping the overall size of the repo market.

Further, the authors fear that the migration of this business introduces *new* risks, as nonbanks face fewer regulations than banks and could be less able to withstand a downturn in asset prices. The authors also note that as banks pull back from the traditional repo business, they reduce overall liquidity in that business, even as their heavier investments in volatile markets, such as equities, damage their ability to withstand a shock.

Whether one is concerned about these compelling results depends on whether one prefers the government to determine assets' riskiness or to allow financial firms to do that job. In a robust financial market that allows for firm failure, there is nothing wrong with a firm making catastrophic repo bets on supposedly riskier assets, such as equities and corporate bonds—and failing.

Further, the financial crisis occurred, in part, because financial firms invested too heavily in mortgage-backed bonds and other securities that the government had deemed non-risky. The U.S. government's implementation of the Basel rule is positive in that it gives financial firms, not the government, more responsibility for assessing risk.

The government should regulate bank broker-dealers and nonbank broker-dealers equivalently: to ensure that nonbank broker-dealers do not gain an advantage in the mortgage-backed securities market; and to ensure that the next credit crisis doesn't come from a seizure in *nonbank* credit markets.

Another study, too, concludes that in regulating risk, the government has only moved that risk somewhere else. In "Macroprudential Lessons from the Leveraged Lending Guidance: The Revolving Door of Risk," Sooji Kim, Matthew Plosser, and Joao Santos of the Federal Reserve Bank of New York studied leveraged loans (i.e., loans approved for corporate borrowers that already have high debt levels).

These loans carry a high interest rate, typically at least 2.5% above low-risk rates. In 2014, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, all major bank regulators, used their authority under existing laws to clarify new guidance that they had announced the previous year concerning the issuance of leveraged loans. The guidance didn't prohibit any behavior or impose any penalties, but it reiterated underwriting and other lending standards.

In response, large banks covered by the new guidance reduced their leveraged lending, the researchers found, between 2011 (before regulators announced the guidance) and 2015 (after they finalized it). One might consider this result salutary: the government cautioned banks to take less risk, and they followed suit. (Small banks, not affected by the regulation, did not change their behavior.)

However, the researchers also note that, as large banks reduced their activity in the leveraged-loan market, nonbanks, unaffected by the guidance, increased it. Before the government's new guidance, large banks made 185 leveraged loans in an average month, totaling $25.1 billion. After the government issued and clarified the guidance, they made just 142, totaling $19.4 billion. Before the guidance, nonbanks made 23 such loans per month, totaling $1.5 billion. After the clarified guidance, they made 32, totaling $2.8 billion.

Also worrisome, nonbanks were able to offer more leveraged loans because they themselves had borrowed from the banks. Nonbank borrowing from banks for leveraged loans was $8.9 billion over the two years leading up to 2013—and $20.2 billion after the clarified guidance. The authors further note that nonbanks could face a cap on how much lending they can provide, constrained in part by how much banks can and will lend for this purpose.

Still, the authors worry that the government, far from reducing a risk, simply caused the risk to migrate to a less regulated area of the financial system. As the authors observe of government regulation in general, "it is not enough to consider targeted institutions' responses to those [regulatory] policies. Rather, one also needs to take into account the feedback effects that may be triggered by those responses."

Consumer Protection: Reducing Costs or Transferring Them?

Two other papers that the Manhattan Institute commissioned examine new regulations to protect consumers: one protecting bank-account holders, and the other protecting individual borrowers. In both cases, researchers found that new regulations transferred some consumer costs rather than reduced or eliminated them.

To protect bank-account holders, Dodd-Frank capped the fees that banks with over $10 billion in assets can charge retailers and other merchants for customers' debit-card use, theoretically reducing costs for customers by reducing retailers' own costs.

In "Competition and Complementarities in Retail Banking: Evidence from Debit-Card Interchange Regulation," Benjamin Kay of the U.S. Department of the Treasury and Mark Manuszak and Cindy Vojtech of the Federal Reserve Board note that, before Dodd-Frank, fees averaged 44 cents on an average $38 transaction. The law capped such fees at about 24 cents for the same transaction: 21–22 cents as a flat fee, then 0.05% of the transaction value. This cap resulted in a big loss for the banks that the researchers studied: 28% of their $14.6 billion in such revenue in 2010, or $4.1 billion.

But, the authors find, the banks were able to offset 90% of this loss by charging customers higher bank-account fees. Banks increased depositors' fees by 15%. This hike "offset effectively all of the lost interchange income at treated banks," the researchers note.

The final result didn't help bank-account holders and also pointed to a deeper problem: the lack of competition among large banks. The authors conclude that "large banks have substantial market power over their retail customers."

The CARD Act was a stand-alone act meant to help credit-card borrowers. In a separate study, "The Credit-Card Act and Consumer Finance Company Lending," Gregory Elliehausen and Simona Hannon of the Federal Reserve Board research whether the CARD Act succeeded.

The authors note that until the late 1970s, credit cards issued by banks were rare, with banks approving credit largely for lower-risk, high-income customers. Card companies faced state ceilings on interest rates. As regulations eased, credit-card companies were able to charge higher interest rates to less creditworthy borrowers, also called nonprime borrowers, and expanded their offerings accordingly.

The 2009 CARD Act restricted card issuers' ability to charge borrowers higher rates and fees. As a result, card issuers pulled back from lending to lower-credit borrowers. By 2010, the percentage of low-credit people holding credit cards had fallen from 70%, before the financial crisis, to 50%.

As the CARD Act went into effect in 2010, nonprime borrowers lost even more of their already-straitened access to credit compared with prime borrowers. Nonprime consumers eventually held just 66% of the credit-card accounts that they had held before the crisis and before the new regulations. Prime consumers, by contrast, retained 81%–84% of their credit-card accounts.

Both prime and nonprime consumers held fewer bank-card accounts after the financial crisis; but nonprime consumers' holdings fell more and continued to fall during the recovery from recession. Though much of the early pullback was because both lenders and borrowers wanted to reduce debt, "the larger further declines for nonprime customers likely were caused by the CARD Act's restrictions on risk management practices, which adversely affected higher risk consumers," Elliehausen and Hannon note.

Much of this high-interest-rate lending didn't disappear, though. It moved to an older and, in many states, less regulated corner of the financial market: cash loans made by consumer-finance companies. To be sure, nonprime borrowers have always relied more heavily on consumer-finance loans than have prime borrowers. Before the financial crisis, in states whose regulations allow for high-interest-rate consumer loans, nonprime borrowers had 33% more consumer-loan accounts than did prime borrowers. (Borrowing rates for both groups were lower in states that cap interest rates, as the caps make such lending less profitable.)

After the CARD Act took full effect, such borrowers held 13% fewer such accounts than prime borrowers. But nonprime borrowers in less regulated states reduced their reliance on credit-card debt much more sharply. "Higher-risk consumers may have been able to substitute consumer finance credit for reduced access to bank-card credit when consumer finance rate ceilings did not restrict availability of such credit," the authors note.

This conclusion requires further research. As Benjamin Kay of the Treasury Department suggests, the authors should consider whether conditions specific to certain high-interest states, such as the oil-price decline and regional unemployment levels, affect their results.

However, the evidence thus far supports a compelling conclusion: if regulators cap interest rates in one area of the nonprime market, many borrowers will choose another area of the nonprime market. The authors note further that this switch carries a cost, as consumer-finance loans are more expensive than high-interest credit cards in the nonprime market. Just as with leveraged loans, regulators looking to rein in a particular marketplace should consider that marketplace as a whole, rather than focus on particular providers or products.

Too Big to Fail: A Glimmer of Hope

A key way through which Dodd-Frank aims to end too-big-to-fail is by preventing financial firms from failing in the first place. To that end, the law mandates regular stress tests for financial firms with assets above $10 billion, with more onerous tests for banks with assets above $100 billion. The first such test was in 2009. Many observers fear that the tests perpetuate too-big-to-fail, rather than eliminate it, because Dodd-Frank treats large banks differently, implying that their failure would be too catastrophic for the economy to withstand.

This fear is unfounded, according to Viral Acharya of New York University, Allen Berger of the University of South Carolina, and Raluca Roman of the Federal Reserve Bank of Kansas City, in "Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?." They present evidence that the largest banks are reducing their credit risk in response to the stress tests—i.e., these banks are holding significantly higher levels of capital, are investing in lower-risk assets (as designated by regulators), and are charging higher interest rates to corporate borrowers, even after controlling for borrower risks such as size and existing debt.

Large banks are also lending less to commercial real-estate and small-business ventures, both of which are perceived as relatively risky. "These banks may be managing their credit risk more carefully," the authors conclude, rather than using the tests as evidence that they are too big to fail.

Of course, large banks have other reasons to increase loan spreads. Reduced competition, for instance, means that corporate borrowers without access to global bond markets have less choice about the terms of their loans. In addition, it's unclear if this more careful stewardship of shareholder assets will persist as the financial crisis fades into history. In early 2016, an executive at a large bank called for regulatory easing. Banks also have reasons to pass stress tests other than to demonstrate that they are not too big to fail, including a desire to distribute capital to investors or to maintain their credit ratings.

Finally, though the authors don't address the broader issue, the premise that the stress tests can help reduce the too-big-to-fail risk is flawed. By certifying large banks' stress-test results, the government still signals to the marketplace that it retains responsibility for such banks' success or failure. Banks could indeed be reining in their credit risk. But if they or the government miscalculates in this endeavor, Dodd-Frank still allows for the government to take over large banks' operations for up to five years, guaranteeing their debt and other obligations if necessary.

Conclusion

For more than half a decade, banks have operated in a different regulatory environment relative to the one that governed them before 2008. It is too early to tally the full effects of laws such as Dodd-Frank, the CARD Act, the new rules under Basel, and other preexisting regulatory frameworks. It is not too early, though, to worry that new laws and rules have created unintended consequences that harm economic growth and competition, fail to help consumers, and perpetuate too-big-to-fail.

President Trump is correct to call for a review of current financial-services laws and regulations. But the complexities and interrelationships of financial regulation—including, but not limited to, Obama-era changes—will make wholesale change hard and ensure that any change brings its own unintended consequences.

Appendix: Eight Forthcoming Financial-Regulation Papers Commissioned by the Manhattan Institute

"Differential Bank Behaviors Around the Dodd-Frank Act Size Thresholds"

- **Christa Bouwman**, Texas A&M University
- **Shuting Hu**, Texas A&M University
- **Shane Johnson**, Texas A&M University

"How the Dodd-Frank Act Affected Bank Acquisition Behavior"

- **Shradha Bindal**, Texas A&M University
- **Christa Bouwman**, Texas A&M University
- **Shane Johnson**, Texas A&M University

"Do Higher Capital Standards Always Reduce Bank Risk? The Impact of the Basel Leverage Ratio on the U.S. Triparty Repo Market"

- **Meraj Allahrakha**, U.S. Department of the Treasury
- **Jill Cetina**, U.S. Department of the Treasury
- **Benjamin Munyan**, Vanderbilt University

"Macroprudential Lessons from the Leveraged Lending Guidance: The Revolving Door of Risk"

- **Sooji Kim**, Federal Reserve Bank of New York
- **Matthew Plosser**, Federal Reserve Bank of New York
- **Joao Santos**, Federal Reserve Bank of New York

"Bank Liquidity Management and Bank Capital Shocks"

- **Robert DeYoung**, University of Kansas
- **Isabelle Distinguin**, University of Limoges
- **Amine Tarazi**, University of Limoges

"Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?"

- **Viral Acharya**, Reserve Bank of India; New York University
- **Allen Berger**, University of South Carolina
- **Raluca Roman**, Federal Reserve Bank of Kansas City

"The Credit-Card Act and Consumer Finance Company Lending"

- **Gregory Elliehausen**, Board of Governors of the Federal Reserve System
- **Simona Hannon**, Board of Governors of the Federal Reserve System

"Competition and Complementarities in Retail Banking: Evidence from Debit-Card Interchange Regulation"

- **Benjamin Kay**, U.S. Department of the Treasury
- **Mark Manuszak**, Board of Governors of the Federal Reserve System
- **Cindy Vojtech**, Board of Governors of the Federal Reserve System

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Abstract

For more than half a decade, banks have operated in a different regulatory environment relative to the one that governed them before 2008. It is too early to tally the full effects of laws such as Dodd-Frank, the CARD Act, the new rules under Basel, and other preexisting regulatory frameworks. It is not too early, though, to worry that new laws and rules have created unintended consequences that harm economic growth and competition, fail to help consumers, and perpetuate too-big-to-fail.

President Trump is correct to call for a review of current financial-services laws and regulations. But the complexities and interrelationships of financial regulation—including, but not limited to, Obama-era changes—will make wholesale change hard and ensure that any change brings its own unintended consequences.

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